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Mr. Jonathan G. Katz
Secretary, Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Reference: File S7-20-01
ACTIVELY MANAGED EXCHANGE-TRADED FUNDS

Dear Mr. Katz:

The following is submitted in response to the Commission's request for comment on the desirability of the Commission's approval of Exchange trading of Actively Managed Exchange Traded Funds (ETFs). The comments contained in this letter are solely those of myself and do not necessarily represent the views of the iShare Funds of which I am Chairman and President, nor those of any organization for which I serve as a consultant, including those of Barclays Global Investors.

As a background to my comments, for nineteen years, the American Stock Exchange (AMEX) employed me as head of the Exchange's New Product Development Division. For the first three of those years, I designed and organized the AMEX Commodities Exchange (ACE), for which I then served as President. During the later part of my employment at the AMEX, I developed the design of the Standard & Poor's Depository Receipt (SPDR), which was filed for approval by the Commission in 1990.

This was the first of what are now known as ETFs, and the operating system design on which all subsequent ETFs following that original design have been based. During 1994 and 1995, while still employed by the AMEX, I worked closely with the group designing the investment company funds known as the WEBS. Defining characteristics of these initial designs include highly transparent Fund portfolios, payment for Fund shares with portfolios of securities, and trade execution facilities that facilitate arbitrage opportunities when the value the Fund's shares trading on the stock exchange diverges from the NAV value of the Fund itself.

The term "exchanged traded funds" (ETFs) has become the accepted designation for securities based not only on the original design, but for others, which do not follow that design. I consider this unfortunate in that the term ETF can be applied equally well to closed end funds and to other instruments which neither track the value of the Fund itself nor provide other features of the original SPDR design.

In this letter, to distinguish the design of the first ETF, the SPDR, from some portfolio securities which trade on a stock exchange but do not include all of the features of that original design; I will refer to the original design securities as ETFOs with the added "O" referring to "original".

All ETFOs currently trading in the U.S are based on known indexes. In the case of the SPDR, the S&P 500 Index was selected as its reference base because it is the Index most widely followed by U.S. institutions and because that index has a very active futures contract based on it. That contract provides a good hedging mechanism for the ETFO. In actuality, the ETFO design can operate successfully with any portfolio of stocks providing the composition of the fund is transparent, the portfolio stocks have a high degree of trading liquidity, and all of the design mechanisms of the ETFO are provided.

The design mechanism by which the NAV of the ETFO shares are caused to track the NAV of the underlying fund portfolio during trading is relatively simple. Since payment for ETFO shares purchased directly from the Fund is only by delivery of a creation basket of stocks, not cash (except for a minor balancing amount), and since the composition of that basket is required to closely match the proportional composition of the shares held by fund, if the price at which the ETFO shares are trading should exceed the cost of buying the creation stock basket, then by selling the ETFO shares and purchasing and delivering the creation basket of stocks to the Fund to acquire the ETFO shares sold, an arbitrage profit can be earned.

Although an arbitrageur could purchase the creation basket of shares at any time, payment must be made to the Fund at the close of trading at the Fund's NAV. Since the creation basket shares purchased have the same proportional composition as that of the fund, at the time of delivery, the NAV of both will be very close. A reverse type of transaction can also be executed if the ETFO shares should be selling for less than the NAV value of the fund.

To actually accomplish such arbitrages requires the existence of a complex system of high-speed order execution plus fast clearing and security delivery systems. Further, the fund's shares must have a high degree of trading liquidity to accommodate such trades. Fortunately most of these requirements existed when the ETFO was initially designed, with the exception of the special clearing system permitting physical share delivery. Fortunately, NSCC undertook to design and built a system to accomplish this.

Especially important is that the composition of the fund on which the NAV calculation is based and that of the matching ETFO creation basket not be changed during the trading day. Trades executed by fund managers to take account of changes made by an Index provider or to take account of corporate actions are recorded on the following day.

It will be noted that the mechanism causing the ETFO share's NAV to closely track that of the Fund does not function simply by revealing the composition of the fund's holdings each day. Instead, the entire mechanism for executing arbitrage transactions, trading, clearing, and payment by delivery of creation basket shares, must all be in place to cause such tracking to occur.

There are a number of other features of the ETFO type design, which are unique, but it is the design components required for the tracking mechanism to function, which are of particular importance in considering whether or not a particular ETF design type is in fact an ETFO security.

IV. Areas for Comment

A. <u>Index Based ETFOs vs Actively Managed ETFs</u>.

Currently, most mutual funds are of the actively managed type. It has proven to be very difficult for retail investors to accept the evidence that few fund managers are able to better large market index investing over any extended period of time. A very high percentage of ETFO index based investments have been by institutional organizations that are able to evaluate the advantages of such investments.

Permitting the ETFO design to be applied to managed funds would not retain the benefits of index investing. The question is therefore whether applying the remaining features of the true ETFO design to managed funds would be of public benefit.

The managed fund types that might seek to utilize at least part of the ETFO design, range from funds which would fully disclose their portfolio compositions and include all of the ETFO's mechanisms and operating design, to funds which would disclose nothing of their holdings, other than as required by '40 Act. Between these limits, funds with different combinations of partial portfolio disclosure would be possible. In order to minimize risks to investors these funds would need to provide a degree of tracking during the trading day so that secondary market prices of the ETF would have some relation to the NAV of the Fund.

The advantages of the ETFO design over standard type mutual funds, including lower operating costs, reduction of capital gains distributions, transparency of holdings, ability to purchase or sell during the trading day, etc., other than the value of index investing, have been adequately explained in many publications. The very rapid growth of investing in these funds and especially their spread to basing on the smaller and more specialized indexes and to other countries is certainly a confirmation of these advantages.

A valid question is whether all of the features of the ETFO design other than indexing, can be utilized for managed type funds. It is clear that index fund managers do change Index fund compositions from time to time, often on a regular basis. Corporate actions cause such changes in substantial numbers. Managed funds utilizing the ETFO design would experience even more frequent changes, which would result in higher management and transaction costs than those based on indexes..

With respect to the value of managed funds using only part of the ETFO design; certain benefits would apply such as reduction in the cost of maintaining a transfer function. However, only partial disclosure of the fund portfolio and absence of the ETFO tracking mechanism would be unlikely to provide the degree of tracking required to permit arbitrage transactions to be executable. Further, if large cash component were made part of the creation baskets, the tax reduction benefits of the ETFO design would be minimized..

Certain foreign ETFs currently do provide for cash purchasing only. These cases are because of regulations imposed by certain foreign governments, which do not permit physical share payments for ETFOs. In these cases the funds do disclose their holdings each day and there are index futures contracts on which it is possible to lay off the risk of purchasing and selling the ETF shares.

CONCLUSIONS AND RECOMMENDATIONS

If the Commission accepts the fact that it is possible to apply all of the ETFO design benefits, other than index basing, to managed funds, there would appear to be little reason for not granting exemptive relief to those funds, which do strictly adhere to the ETFO design. There has now been almost eight years of trading experience with the ETFO securities with very few, if any problems of any magnitude..

With respect to those managed funds which would not utilize all of the systems of the ETFO type securities, I suggest that the Commission carefully consider the risks to investors before granting exemptive relief. A significant danger to the investing public would be the possibility of misleading them into thinking that such funds have the attributes of the ETFO design. Some might argue that such confusion could be dealt with in the fund's prospectus. Unfortunately, few retail investors actually read fund prospectuses, especially one that would attempt to explain the technical differences and the possible result on investment returns.

In summary, I believe that managed funds embodying all of the features of the ETFO design could be of benefit to the investing public. It would make available to them funds similar to those, which they currently purchase while providing them with the additional advantages of the ETFO type securities.

Respectfully submitted,

Nathan Most